

Ten Months Ended December 31, 1995 Compared to the Ten Months Ended December 31, 1994

Revenues from continuing operations for the ten months ended December 31, 1995 increased by \$2.2 million, or 16%, to \$15.8 million, from \$13.6 million in the comparable period of the prior year. This increase was attributable to increased revenues in the Company's information services line of business. During the ten months ended December 31, 1995, the Carrier Services business had only nominal revenues. The information services line of business, which reported nominal revenues in the prior year, had revenues of approximately \$2.6 million for the ten months ended December 31, 1995, related primarily to the completion of certain documentary television products.

Cost of services and products for the ten months ended December 31, 1995 increased by \$2.7 million, to \$12.1 million, from \$9.4 million for the ten months ended December 31, 1994. The increase was principally attributable to the growth in the Company's information services line of business, along with initial expenses incurred in connection with the Company's telecommunications network.

Selling, general and administrative expenses increased by \$5.7 million to \$13.6 million, or 86% of revenues, for the ten months ended December 31, 1995, from \$7.9 million, or 58% of revenues, in the comparable period of the prior year. Factors contributing to the increase were: the acquisition of Avant-Garde Telecommunications, Inc. ("Avant-Garde," the original holder of many of the Wireless Licenses) and the consolidation of that entity's results of operations into the Company's financial statements from July 17, 1995 onward; the hiring of additional personnel; and the expansion of the Company's infrastructure to manage future growth in its telecommunications business.

For the reasons noted above, the operating loss for the ten months ended December 31, 1995, was \$10.9 million, compared to an operating loss of \$3.9 million in the comparable period of the prior year.

Interest expense increased by \$6.9 million to \$7.2 million for the ten months ended December 31, 1995, from \$0.3 million for the ten months ended December 31, 1994, reflecting principally the non-cash accretion of interest on certain indebtedness issued in the 1995 Debt Placement.

Interest income for the ten months ended December 31, 1995 increased by \$2.6 million, to \$2.9 million, compared with \$0.3 million for the same period during the prior year. The increase was attributable to earnings on the 1995 Debt Placement, which raised net proceeds of \$214.5 million.

For the reasons noted above, the Company reported a net loss of \$15.9 million for the ten months ended December 31, 1995, compared to a net loss of \$4.6 million in the comparable period of the prior year.

Liquidity and Capital Resources

In February 1997, the Company and a subsidiary sold 4,000,000 shares of its 6% Series A Cumulative Convertible Preferred Stock and warrants to purchase 1,600,000 shares of Common Stock in a private placement, pursuant to which they realized aggregate net proceeds of approximately \$96.0 million.

In March 1997, the Company sold \$100.0 million principal amount of 14½% Senior Deferred Interest Notes Due 2005 and a subsidiary, WinStar Equipment Corp. ("WEC") sold \$200.0 million principal amount of 12½% Guaranteed Senior Secured Notes Due 2004 ("WEC Notes") in a private placement, pursuant to which they realized net proceeds of approximately \$290.5 million. In August 1997, another subsidiary, WinStar Equipment II Corp. ("WEC II") sold \$50.0 million principal amount of 12½% Guaranteed Senior Secured Notes Due 2004 ("WEC II Notes," and, together with the WEC Notes, the "Equipment Notes") in a private placement, generating net proceeds of approximately \$48.5 million. In October 1997, the Company sold \$100.0 million principal amount of 15% Senior Subordinated Deferred Interest Notes Due 2007 in a private placement, realizing net proceeds of approximately \$94.0 million. Under the terms of the Equipment Notes, the principal amount thereof must be utilized by March 18, 1999 and August 8, 1999, respectively, to purchase designated equipment or for the redemption of the Equipment Notes. See Note 21 of the Consolidated Financial Statements included elsewhere in this Report for a description of the operations of WEC and WEC II.

In December 1997, the Company and one of its subsidiaries sold 175,000 shares of the Company's 14¼% Senior Cumulative Exchangeable Preferred Stock Due 2007, pursuant to which they realized net proceeds of approximately \$168.0 million.

At December 31, 1997, the Company had approximately \$419.3 million in cash, cash equivalents and short-term investments, of which approximately \$183.0 million is to be used to finance equipment purchases and related costs in connection with the Company's rollout of its telecommunications infrastructure in accordance with the terms of the Equipment Notes and \$92.0 million was used in January 1998 for the purchase of assets of Midcom.

In March 1998, (i) the Company and a subsidiary consummated a private placement of \$200.0 million of the Company's 7% Senior Cumulative Convertible Series D Preferred Stock, (ii) the Company consummated private placements of \$200.0 million of its 10% Senior Subordinated Notes Due 2008 (the "Cash Pay Notes") and \$250.0 million of its 11% Senior Subordinated Deferred Interest Notes Due 2008, and (iii) a subsidiary of the Company consummated a sale leaseback of certain telecommunications switches acquired by the Company from US One in October 1997, which is expected to generate net proceeds of approximately \$42.0 million.

The Company has incurred significant operating and net losses, due in large part to the development of its telecommunications services business, and anticipates that such losses will continue over the near term as the Company executes its growth strategy. A significant portion of the Company's capital requirements will result from the rollout of the Company's CLEC business. The Company is building a direct sales force, having opened sales offices serving each of the markets in which it offers CLEC services, and is in the process of expanding into other metropolitan areas. Additionally, the Company is in the process of ordering and installing switching and other network equipment to be placed in its key markets. Historically, the Company has funded its operating losses and capital expenditures through public and private offerings of debt and equity securities and from credit and lease facilities. Cash used to fund negative EBITDA during the year ended December 31, 1997 was approximately \$158.0 million, and purchases of property and equipment during the year ended December 31, 1997 was approximately \$222.3 million. At December 31, 1997, the Company's working capital totaled \$366.0 million and its cash, cash equivalents and short-term investments were \$419.3 million, as compared to working capital of \$108.7 million and cash, cash equivalents and short-term investments of \$122.5 million at December 31, 1996.

Other than the Equipment Notes and the Cash-Pay Notes and certain capitalized lease obligations, each of which requires periodic cash interest or equivalent payments, the Company's principal indebtedness does not require the Company to pay cash interest until 2001.

The Company has the ability to moderate its capital spending and EBITDA losses by varying the number of markets in which it builds network and offers service. In the event that the Company slows the speed or narrows the focus of its business plan, the Company will reduce its capital requirements and EBITDA losses. Under its current plans to expand to 40 major metropolitan markets on a switched basis by the end of 1999, the Company plans to spend approximately \$300.0 million in each of 1998 and 1999 for capital equipment, which may require the Company to seek additional capital from financial institutions, equipment vendors or in the financial markets. The Company anticipates, based on current plans and assumptions relating to its operations, that existing financial resources, together with additional equipment and accounts receivable financing arrangements that the Company intends to seek, will be sufficient to fund the Company's operations and capital requirements for approximately 18 to 30 months from the date of this Report. The Company believes that it will be able to obtain sufficient capital to execute its business plan. In the event that the Company's assumptions change or prove to be inaccurate, the Company consummates any acquisitions of significant businesses or assets (including spectrum licenses other than those being acquired by the Company in the recently completed auction of LMDS Licenses, by auction or otherwise), the Company accelerates its plan and enters markets more rapidly, or the Company fails to secure additional equipment financing arrangements, the Company may be required to seek additional sources of capital sooner than currently anticipated.

In addition to binding commitments to purchase \$31.0 million of telecommunications capital equipment, the Company had commitments to pay approximately \$55.0 million in Common Stock, or at the Company's election, cash, in connection with the acquisition of additional spectrum licenses, of which shares having a value of approximately \$28.5 million were issued in March 1998. Additionally, the Company was the highest bidder on certain LMDS Licenses in the LMDS Auction and has committed to pay approximately \$30.0 million in connection therewith (in addition to the Company's \$13.0 million initial downpayment in such auction).

Year 2000 Compliance

The Company has completed a review of its computer systems and operations to determine the extent to which its systems will be vulnerable to potential errors and failures as a result of the "Year 2000" problem. The Year 2000 problem is the result of prior computer programs being written using two digits, rather than four digits, to define the applicable year. Any of the Company's programs that have time-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in major system failure or miscalculations.

The Company has concluded that its significant computer programs and operations will not be affected by the Year 2000 problem and that the programs that will be affected can and will be properly modified or replaced by the end of 1999 at a cost which will not be significant to the Company.

However, to the extent that other telecommunications carriers in the national telecommunications infrastructure, including carriers whose services are resold by the Company or to which the Company's network is interconnected directly or indirectly, are not Year 2000 compliant, there can be no assurance that such resulting problems will not have a material adverse effect on the Company.

Effect of Recently Issued Accounting Pronouncements

The Financial Accounting Standards Board released Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (SFAS No. 130), governing the reporting and display of comprehensive income and its components, and Statement of Financial Accounting Standards No. 131, "Disclosures About Segments of an Enterprise and Related Information" (SFAS No. 131), requiring that all public businesses report financial and descriptive information about their reportable operating segments. The Company will implement SFAS 130 and SFAS 131 as required in 1998. The impact of adopting SFAS No. 130 is not expected to be material to the consolidated financial statements or notes to consolidated financial statements. Management is currently evaluating the effect of SFAS No. 131 on consolidated financial statement disclosures.

Forward-Looking Statements

This Report contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve certain risks and uncertainties. Such forward-looking statements are contained in the sections "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business-Business Strategy," among others. In addition, in those and other portions of this Report, the words "anticipate," "believe," "estimate," "expect," "plan," "intend" and similar expressions, as they relate to the Company, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. No assurance can be given that any of such expectations will be realized. Factors that may cause actual results to differ materially from those contemplated by such forwardlooking statements include, without limitation: (a) the Company's ability to service its debt or to obtain financing for the buildout of its telecommunications network; (b) the Company's ability to attract and retain a sufficient revenue-generating customer base; (c) competitive pressures in the telecommunications industry; and (d) general economic conditions.

Item 8. Financial Statements and Supplementary Data

The financial statements required by Item 8 are included in this Report beginning on Page F-1.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

PART III

The information required by Items 10, 11, 12 and 13 of Form 10-K is incorporated herein by reference to the Company's Proxy Statement for the Annual Meeting of Stockholders anticipated to be held on June 10, 1998.

ITEM 14. Exhibits, List and Reports

(a) Exhibits

<u>EXHIBIT NUMBER</u>	<u>DESCRIPTION</u>
3.1	— Restated Certificate of Incorporation of the Company (Incorporated by reference to Exhibit to the Company's Registration Statement on Form S-18 (No. 33-37024))
3.2	— Amendment to Restated Certificate of Incorporation of the Company effecting name change from "Robern Apparel, Inc." to "Robern Industries, Inc." (Incorporated by reference to Exhibit 3.1(b) to the Company's Registration Statement on Form S-4 (No. 33-52716))
3.3	— Second Amendment to Restated Certificate of Incorporation of the Company effecting name change from "Robern Industries, Inc." to "WinStar Communications, Inc." (Incorporated by reference to Exhibit 3.1(b) to the Company's Registration Statement on Form S-1 (No. 33-43915))
3.4	— Certificate of Designations, Preferences and Rights of Series A Preferred Stock (Incorporated by reference to Exhibit 3.7 to the Company's Current Report on Form 8-K filed February 14, 1997)
3.5	— Certificate of Designations, Preferences and Rights of Series B Preferred Stock (Incorporated by reference to Exhibit 4 to the Company's Current Report on Form 8-K filed July 2, 1997)
3.6	— Certificate of Designations, Preferences and Rights of Series C Preferred Stock (Incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed December 24, 1997)
3.7	— Certificate of Designations, Preferences and Rights of Series D Preferred Stock (Incorporated by reference to Exhibit 2 to the Company's Current Report on Form 8-K filed March 30, 1998)
3.8	— By-Laws of the Company (Incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-18 (No. 33-37024))
10.1	— 1992 Performance Equity Plan (Incorporated by reference to Exhibit 10.53 to the Company's Registration Statement on Form S-18 (No. 33-37024))
10.2	— 1995 Performance Equity Plan (Incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8 (No. 333-31057))
10.3	— Employment Agreement between the Company and William J. Rouhana, Jr. (filed herewith)
23.1	— Consent of Grant Thornton LLP to Incorporate Financial Statements included in this Report on Form 10-K into the Company's Registration Statements on Forms S-3, Form S-4 and Forms S-8 (filed herewith).
(b)	— Reports on Form 8-K <ol style="list-style-type: none">(1) Current Report on Form 8-K filed October 29, 1997;(2) Current Report on Form 8-K filed October 31, 1997; and(3) Current Report on Form 8-K filed December 24, 1997.

Copies of the exhibits listed above will be made available by the Company to any stockholder upon written request of the stockholder addressed to WinStar Communications, Inc., 230 Park Avenue, Suite 2700, New York, New York 10169, Attention: Investor Relations. Any stockholder requesting a copy of any such exhibit will be charged a copying fee of \$.25 per page.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 30th day of March, 1998.

WINSTAR COMMUNICATIONS, INC.

By: /s/ WILLIAM J. ROUHANA, JR.
 William J. Rouhana, Jr.
*Chairman of the Board and
 Chief Executive Officer*

In accordance with Section 13 or 15(d) of the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ WILLIAM J. ROUHANA, JR.</u> William J. Rouhana, Jr.	Chairman of the Board of Directors, Chief Executive Officer and Director	March 30, 1998
<u>/s/ STEVEN G. CHRUST</u> Steven G. Chrust	Vice Chairman and Director	March 30, 1998
<u>/s/ NATHAN KANTOR</u> Nathan Kantor	President, Chief Operating Officer and Director	March 30, 1998
<u>/s/ STEVEN B. MAGYAR</u> Steven B. Magyar	Director	March 30, 1998
<u>/s/ WILLIAM J. VANDEN HEUVEL</u> William J. vanden Heuvel	Director	March 30, 1998
<u>/s/ BERT WASSERMAN</u> Bert Wasserman	Director	March 30, 1998
<u>/s/ JAMES I. CASH</u> James I. Cash	Director	March 30, 1998
<u>/s/ CHARLES T. DICKSON</u> Charles T. Dickson	Executive Vice President and Chief Financial Officer (principal financial officer)	March 30, 1998
<u>/s/ JOSEPH P. DWYER</u> Joseph P. Dwyer	Vice President-Finance (principal accounting officer)	March 30, 1998

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors
WinStar Communications, Inc.

We have audited the accompanying consolidated balance sheets of WinStar Communications, Inc. and Subsidiaries as of December 31, 1996 and 1997, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for the ten months ended December 31, 1995 and the years ended December 31, 1996 and 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of WinStar Communications, Inc. and Subsidiaries as of December 31, 1996 and 1997 and the consolidated results of their operations and their consolidated cash flows for the ten months ended December 31, 1995 and the years ended December 31, 1996 and 1997, in conformity with generally accepted accounting principles.

GRANT THORNTON LLP
New York, New York
February 12, 1998

Balance Sheets

(In thousands)

	DECEMBER 31, 1996	DECEMBER 31, 1997
ASSETS		
Current assets		
Cash and cash equivalents	\$ 95,490	\$ 402,359
Short term investments	26,997	16,903
Cash, cash equivalents and short term investments	122,487	419,262
Investments in equity securities	688	—
Accounts receivable, net of allowance for doubtful accounts of \$852 and \$3,819, respectively	13,150	30,328
Inventories	5,009	10,296
Prepaid expenses and other current assets	15,969	8,985
Net assets of discontinued operations	3,814	2,105
Total current assets	161,117	470,976
Property and equipment, net	62,572	284,835
Licenses, net	27,434	174,763
Intangible assets, net	12,955	14,293
Deferred financing costs, net	10,535	27,463
Other assets	4,176	4,071
Total assets	<u>\$ 278,789</u>	<u>\$ 976,401</u>
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities		
Current portion of long-term debt	\$ 19,901	\$ 386
Accounts payable and accrued expenses	29,442	97,714
Current portion of capitalized lease obligations	3,110	6,848
Total current liabilities	52,453	104,948
Capitalized lease obligations, less current portion	10,846	21,823
Long-term debt, less current portion	265,161	768,469
Deferred income taxes	—	24,000
Total liabilities	328,460	919,240
Series C exchangeable redeemable preferred stock, liquidation preference of \$175,000 plus accumulated dividends	—	175,553
Commitments and contingencies		
Stockholders' equity (deficit)		
Series A preferred stock issued and outstanding 3,910 shares at December 31, 1997	—	39
Common stock, par value \$.01; authorized 200,000 shares, issued and outstanding 28,989 and 34,610, respectively	290	346
Additional paid-in-capital	75,436	255,741
Accumulated deficit	(125,034)	(374,518)
Unrealized loss on investments	(49,308)	(118,392)
Total stockholders' deficit	(49,671)	(118,392)
Total liabilities, exchangeable redeemable preferred stock and stockholders' deficit	<u>\$ 278,789</u>	<u>\$ 976,401</u>

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES CONSOLIDATED

Statements of Operations

(In thousands, except per share data)

	FOR THE TEN MONTHS ENDED DECEMBER 31, 1995	FOR THE YEAR ENDED DECEMBER 31, 1996	1997
Operating revenues			
Telecommunications services — commercial	\$ 130	\$ 4,487	\$ 29,796
Telecommunications services — residential	13,007	29,482	8,481
Information services	2,648	14,650	41,354
Total operating revenues	15,785	48,619	79,631
Operating expenses			
Cost of services and products	12,073	38,233	81,017
Selling, general and administrative expenses	13,617	62,365	156,959
Depreciation and amortization	1,027	4,501	29,701
Total operating expenses	26,717	105,099	267,677
Operating loss	(10,932)	(56,480)	(188,046)
Other (expense) income			
Interest expense	(7,186)	(36,748)	(77,257)
Interest income	2,890	10,515	17,577
Other (expense) income	(866)	—	2,219
Loss from continuing operations before income tax benefit	(16,094)	(82,713)	(245,507)
Income tax benefit	—	—	2,500
Loss from continuing operations	(16,094)	(82,713)	(243,007)
Income (loss) from discontinued operations	237	(1,010)	(6,477)
Net loss	(15,857)	(83,723)	(249,484)
Preferred stock dividends	—	—	(5,879)
Net loss applicable to common stockholders	<u>\$(15,857)</u>	<u>\$(83,723)</u>	<u>\$(255,363)</u>
Basic and diluted income (loss) per share:			
From continuing operations	\$ (0.71)	\$ (2.96)	\$ (7.49)
From discontinued operations	0.01	(0.04)	(0.19)
Net loss per share	<u>\$ (0.70)</u>	<u>\$ (3.00)</u>	<u>\$ (7.68)</u>
Weighted average shares outstanding	<u>22,770</u>	<u>27,911</u>	<u>33,249</u>

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES CONSOLIDATED
Statements of Stockholders' Equity (Deficit)

For the Ten Months Ended December 31, 1995

(In thousands)

	PREFERRED STOCK				COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	TREASURY STOCK				DEFERRED COMPENSATION	UNREALIZED LOSS ON INVESTMENTS	TOTAL STOCKHOLDERS' EQUITY
	B		E						COMMON STOCK		PREFERRED STOCK B				
	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT			SHARES	AMOUNT	SHARES	AMOUNT			
Balances at February 28, 1995.....	0.73	\$ 733	—	\$ —	20,147	\$201	\$ 42,583	\$(25,238)	—	\$ —	—	\$ —	\$ —	\$ —	\$ 18,279
Issuances of common stock					4,447	45	10,639								10,684
Issuance of preferred stock			932	6,000			(360)								5,640
Conversions of preferred stock	(0.15)	(147)	(932)	(6,000)	684	7	6,140								—
Warrants and common stock equivalents issued in connection with long-term debt and lease financing							981								981
Conversion of long-term debt					539	5	3,410								3,415
Preferred stock dividends	0.11	103						(216)							(113)
Issuance of restricted stock					150	2	1,236						(1,238)		—
Amortization of deferred compensation													138		138
WinStar Private Exchange transaction ...					3,741	37	39,641		(2,507)	(36,348)	(0.69)	(3,330)			—
Unrealized loss on investments in marketable equity securities														(982)	(982)
Other, net							(433)								(433)
Net loss								(15,857)							(15,857)
Balances at December 31, 1995	<u>0.69</u>	<u>\$ 689</u>	<u>—</u>	<u>\$ —</u>	<u>29,708</u>	<u>\$297</u>	<u>\$103,837</u>	<u>\$(41,311)</u>	<u>(2,507)</u>	<u>\$(36,348)</u>	<u>(0.69)</u>	<u>\$(3,330)</u>	<u>\$(1,100)</u>	<u>\$(982)</u>	<u>\$ 21,752</u>

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See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES CONSOLIDATED

Statements of Stockholders' Equity (Deficit)

For the Year Ended December 31, 1996

(In thousands)

	PREFERRED B		COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	TREASURY STOCK				DEFERRED COMPENSATION	UNREALIZED GAIN/(LOSS) ON INVESTMENTS	TOTAL STOCKHOLDERS' EQUITY (DEFICIT)
	SHARES	AMOUNT	SHARES	AMOUNT			COMMON STOCK SHARES	COMMON STOCK AMOUNT	PREFERRED STOCK B SHARES	PREFERRED STOCK B AMOUNT			
Balances at December 31, 1995.....	0.69	\$ 689	29,708	\$ 297	\$103,837	\$ (41,311)	(2,507)	\$ (36,348)	(0.69)	\$ (3,330)	\$ (1,100)	\$ (982)	\$ 21,752
Issuances of common stock			1,383	14	9,619								9,633
Acquisition of treasury shares.....							(150)	(3,056)					(3,056)
Retirement of treasury shares.....	(0.69)	(689)	(2,657)	(27)	(42,018)		2,657	39,404	0.69	3,330			—
Amortization of deferred compensation											1,100		1,100
Conversion of long-term debt			555	6	3,878								3,884
Fair value of stock options granted to nonemployees and other, net					120								120
Unrealized gain on investments in marketable equity securities												619	619
Net loss	—	—	—	—	—	(83,723)	—	—	—	—	—	—	(83,723)
Balances at December 31, 1996.....	<u>—</u>	<u>\$ —</u>	<u>28,989</u>	<u>\$ 290</u>	<u>\$ 75,436</u>	<u>\$ (125,034)</u>	<u>—</u>	<u>\$ —</u>	<u>—</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (363)</u>	<u>\$ (49,671)</u>

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See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES CONSOLIDATED

Statement of Stockholders' Equity (Deficit)

For the Year Ended December 31, 1997

(In thousands)

	PREFERRED STOCK A		COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	UNREALIZED GAIN/(LOSS) ON INVESTMENTS	TOTAL STOCKHOLDERS' EQUITY (DEFICIT)
	SHARES	AMOUNT	SHARES	AMOUNT				
Balances at								
December 31, 1996	—	\$—	28,989	\$290	\$ 75,436	\$(125,034)	\$(363)	\$ (49,671)
Issuances of common								
stock	—	—	1,218	12	8,769	—	—	8,781
Issuances of common								
stock for acquisitions	—	—	3,984	40	83,311	—	—	83,351
Issuance of preferred								
stock Series A	4,000	40	—	—	95,960	—	—	96,000
Dividends declared on								
Series A preferred								
stock	—	—	—	—	(5,326)	—	—	(5,326)
Issuances of Series A								
preferred stock as								
dividends in kind	213	2	—	—	5,324	—	—	5,326
Dividends on Series C								
preferred stock	—	—	—	—	(553)	—	—	(553)
Conversion of Series A								
preferred stock to								
common stock	(303)	(3)	420	4	(1)	—	—	—
Series C preferred stock								
issuance costs and other,								
net	—	—	—	—	(7,179)	—	—	(7,179)
Unrealized gain on								
investments in								
marketable equity								
securities	—	—	—	—	—	—	363	363
Net loss	—	—	—	—	—	(249,484)	—	(249,484)
Balances at								
December 31, 1997	<u>3,910</u>	<u>\$39</u>	<u>34,610</u>	<u>\$346</u>	<u>\$255,741</u>	<u>\$(374,518)</u>	<u>\$ —</u>	<u>\$(118,392)</u>

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES CONSOLIDATED

Statements of Cash Flows

(In thousands)

	FOR THE TEN MONTH PERIOD ENDED DECEMBER 31, 1995	FOR THE YEAR ENDED DECEMBER 31, 1996	1997
Cash flows from operating activities:			
Net loss	\$ (15,857)	\$ (83,723)	\$ (249,484)
Adjustments to reconcile net loss to net cash used in operating activities:			
Net (income) loss from discontinued operations	(237)	1,010	6,477
Depreciation and amortization	1,117	5,977	32,360
Deferred income tax benefit	—	—	(2,500)
Provision for doubtful accounts	855	1,562	5,674
Equity in unconsolidated results of AGT	866	—	—
Non cash interest expense	6,151	35,040	53,506
Decrease (increase) in operating assets:			
Accounts receivable	(4,216)	(3,838)	(24,026)
Inventories	(991)	(1,897)	(9,217)
Prepaid expenses and other current assets	(2,342)	(13,442)	510
Other assets	(865)	(1,940)	(178)
Increase in accounts payable and accrued expenses	4,911	9,795	50,306
Net assets provided by (used in) discontinued operations	90	(1,481)	(4,559)
Other, net	179	186	—
Net cash used in operating activities	<u>(10,339)</u>	<u>(52,751)</u>	<u>(141,131)</u>
Cash flows from investing activities:			
Investments in and advances to AGT	(5,704)	—	—
Decrease (increase) in short-term investments, net	(73,594)	46,597	10,094
Decrease (increase) in other investments, net	(7,497)	6,447	—
Purchase of property and equipment, net	(8,138)	(47,842)	(213,356)
Acquisitions of licenses and other	—	(2,121)	(40,190)
Other, net	(499)	(1,619)	2,494
Net cash (used in) provided by investing activities	<u>(95,432)</u>	<u>1,462</u>	<u>(240,958)</u>
Cash flows from financing activities:			
Proceeds from (repayments) of long-term debt, net	224,200	(2,778)	410,585
Net proceeds from redeemable preferred stock	—	—	168,138
Net proceeds from equity transactions	11,259	6,295	104,781
Proceeds from equipment lease financing	6,998	8,345	9,912
Payment of capital lease obligations	(676)	(2,080)	(4,141)
Other, net	(898)	(1,010)	(317)
Net cash provided by financing activities	<u>240,883</u>	<u>8,772</u>	<u>688,958</u>
Net increase (decrease) in cash and cash equivalents	135,112	(42,517)	306,869
Cash and cash equivalents at beginning of period	<u>2,895</u>	<u>138,007</u>	<u>95,490</u>
Cash and cash equivalents at end of period	138,007	95,490	402,359
Short-term investments at end of period	<u>73,595</u>	<u>26,997</u>	<u>16,903</u>
Cash, cash equivalents and short-term investments at end of period	<u>\$211,602</u>	<u>\$122,487</u>	<u>\$ 419,262</u>

See Notes to Consolidated Financial Statements

Notes to Consolidated Financial Statements

Note 1—Summary of Significant Accounting Policies

Consolidation

The consolidated financial statements include the accounts of WinStar Communications, Inc. and its subsidiaries (collectively, "WinStar" or the "Company"). All material intercompany transactions and accounts have been eliminated in consolidation.

Nature of Business

The Company provides facilities-based voice and data telecommunications services to businesses and other customers in major metropolitan areas throughout the United States. WinStar's licenses provide the Company with the largest amount of 38 GHz radio spectrum in the country, which allows the Company to create a nationwide network on a cost effective basis using its fiber-quality digital capacity in the 38 GHz band to provide its customers with a broad range of attractively priced services, and an alternative to the incumbent local exchange carriers, other competitive local exchange carriers and the interexchange carriers. Additionally, the Company produces, aggregates and distributes information and entertainment content, some of which is distributed as part of its telecommunications service offerings to different services in the market place, as well as through traditional and new media outlets, including television, video, cable, radio and the Internet. The Company's telecommunications services are subject to varying degrees of federal, state and local regulation.

To capitalize on opportunities in the telecommunications industry, the Company is pursuing a rapid expansion of its telecommunications services, which will require significant amounts of capital to finance capital expenditures and anticipated operating losses. The Company may elect to slow the speed or narrow the focus of this expansion in the event it is unable to raise sufficient amounts of capital on acceptable terms.

Fiscal Year

The Company changed its fiscal year end from February 28 to December 31, effective January 1, 1996. Accordingly, these financial statements present the ten-month transition period ended December 31, 1995, and the years ended December 31, 1996 and 1997.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of money market fund investments, short-term certificates of deposit, and commercial paper. Exclusive of cash in banks, cash equivalents at December 31, 1996 and 1997 were \$84.5 million and \$395.3 million, respectively, which approximate fair value.

Short-term Investments

Short-term investments are widely diversified and principally consist of certificates of deposit and money market deposits, U.S. government or government agency securities, commercial paper rated "A-1/P-1" or higher, and municipal securities rated "A" or higher with an original maturity of greater than three months and less than six months. Short-term investments are considered held-to-maturity and are stated at amortized cost which approximates fair value. As of December 31, 1996 and 1997, cash, cash equivalents and short-term investments totaled \$122.5 million and \$419.3 million, respectively.

Inventories

Inventories are composed of film inventories that include direct and indirect production costs, which are amortized to expense in the proportion that revenue recognized during the year for each film bears to the estimated total revenue to be received from all sources under the individual film forecast method. Management's estimate of forecasted revenues exceeds the unamortized costs on an individual program basis. Such forecasted revenue is subject to revision in future periods if warranted by changing market conditions.

Notes to Consolidated Financial Statements—(Continued)**Note 1—Summary of Significant Accounting Policies—(Continued)****Property and Equipment**

Property and equipment is stated at cost. Depreciation and amortization are generally computed using the straight-line method over the estimated useful lives of the related assets.

The Company constructs certain of its own network systems and related facilities. Certain internal costs directly related to the construction of such facilities, including interest and salaries of certain employees, are capitalized. Such costs amounted to approximately \$4.1 million for the year ended December 31, 1997, and were insignificant in prior years.

Costs incurred to develop software for internal use are capitalized as incurred. Such costs amounted to \$452,000, and \$7,091,000 for the years ended December 31, 1996 and 1997, respectively, and were insignificant in prior years.

The Company follows the policy of capitalizing interest expense as a component of the cost of its telecommunications equipment constructed for its own use.

Licenses and Intangible Assets

Licenses and intangible assets are being amortized by the straight-line method over their estimated useful lives.

Goodwill represents the excess of cost over the fair value of assets acquired. The Company's policy is to measure goodwill impairment by considering a number of factors as of each balance sheet date including (i) current operating results of the applicable business, (ii) projected future operating results of the applicable business, (iii) the occurrence of any significant regulatory changes which may have an impact on the continuity of the business, and (iv) any other material factors that affect the continuity of the applicable business. The amortization period for goodwill is determined on a case-by-case basis for each acquisition from which goodwill arises based on a review of the nature of the business acquired as well as the factors cited above (see Note 6).

Income Taxes

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109"). Pursuant to SFAS 109, deferred income taxes are recognized for temporary differences between financial statement and income tax bases of assets and liabilities, loss carryforwards and tax credit carryforwards for which income tax benefits are expected to be realized in future years. A valuation allowance is established to reduce deferred tax assets if it is more likely than not that all, or some portion, of such deferred tax assets will not be realized. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date.

Revenue Recognition

In the telecommunications segment, revenues are recorded upon placing of calls or rendering of other related services. In the information services segment, revenues from film productions are recognized when a program is accepted by the licensee and is available for broadcast. Revenues from the licensing of film productions are recognized when the license period begins and the film is available for broadcast. Revenues from advertising sales are recognized when the related advertising is broadcast.

Basic and Diluted Loss Per Share

Basic and diluted loss per share is calculated by dividing the net loss, after consideration of preferred stock accretion and dividends, by the weighted average number of shares of common stock outstanding during each period. The adoption of Statement of Financial Accounting Standard No. 128, "Earnings Per Share" had no material impact on the presentation of loss per share for the periods presented. Stock options and warrants have been excluded from the calculation of diluted loss per share as their effect would have been antidilutive. (See Notes 13 and 14.)

Notes to Consolidated Financial Statements—(Continued)**Note 1—Summary of Significant Accounting Policies—(Continued)****Concentration of Credit Risk**

Financial instruments which potentially subject the Company to concentration of credit risk consist principally of trade receivables. Concentration of credit risk with respect to these receivables is generally diversified due to the large number of entities comprising the Company's customer base and their dispersion across geographic areas. The Company routinely addresses the financial strength of its customers and, as a consequence, believes that its receivable credit risk exposure is limited. The Company's short term investments and cash equivalents are potentially subject to concentration of credit risk, but such risk is limited due to such amounts being invested in investment grade securities.

Use of Estimates in Preparing Financial Statements

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

Note 2—Acquisitions***Acquisitions of Businesses*****Milliwave Limited Partnership**

On January 2, 1997, a subsidiary of the Company merged with the corporate shareholders of Milliwave Limited Partnership ("Milliwave"), a large holder of 38 GHz licenses in the United States, covering 160 million people in more than 80 major markets. The merger consideration paid by the Company to the shareholders of the corporate partners of Milliwave was \$116.0 million (\$40.7 million in cash and 3.6 million shares of the Company's common stock, which had an aggregate market value of \$75 million). The merger was treated as a "purchase" for accounting purposes with the purchase price principally allocated to licenses. In addition, approximately \$26.5 million of deferred tax liabilities were recorded in connection with the acquisition, with a corresponding allocation to licenses, which will be amortized on a straight-line basis over 40 years. Milliwave had minimal operations prior to its merger into the Company. The accounts of Milliwave have been consolidated into the Company's financial statements as of the date of acquisition.

Unaudited pro forma results of operations (in thousands, except per share data), which reflect the combined operations of the Company and Milliwave as if the merger occurred as of January 1, 1996, are as follows:

	FOR THE YEAR ENDED DECEMBER 31, 1996
Operating Revenues	\$ 47,131
Net Loss	\$ (91,898)
Net Loss Per Share	\$ (2.92)

Local Area Telecommunications, Inc.

In October 1996, a subsidiary of the Company acquired certain assets of Local Area Telecommunications, Inc. ("Locate"), comprising its business as a competitive access provider of local digital microwave distribution services and facilities to large corporations and to interexchange and other common carriers. The assets acquired included multiple 38 GHz licenses in the New York metropolitan area. The purchase price for such assets was \$17.5 million, which was paid in the form of promissory notes, which were paid in 1997 (see Note 7). The acquisition has been

Notes to Consolidated Financial Statements—(Continued)**Note 2—Acquisitions—(Continued)**

accounted for as a “purchase” for accounting purposes, with the majority of the purchase price allocated to licenses, which will be amortized on a straight-line basis over 40 years. The accounts of Locate have been consolidated into the Company’s financial statements as of the date of the acquisition.

Avant-Garde Telecommunications, Inc.

Avant-Garde Telecommunications, Inc. (“Avant-Garde” or “AGT”) was a privately held company which held 38 GHz radio licenses granted by the FCC in September 1993. Through July 17, 1995, the Company owned 49% of Avant-Garde, which it acquired for \$4.9 million, and accounted for its investment in Avant-Garde under the equity method. For the period from March 1, 1995 to July 17, 1995, Avant-Garde had net losses of \$1.8 million. On July 17, 1995, pursuant to the terms of a merger agreement, the Company exchanged 1,275,000 restricted shares of its common stock valued at \$5.1 million for the 51% of Avant-Garde that it did not already own. The acquisition of Avant-Garde has been treated as a “purchase” for accounting purposes, with \$12.6 million allocated to the licenses acquired, which are being amortized on a straight-line basis over 40 years. The accounts of Avant-Garde have been consolidated into the Company’s financial statements as of the date of the acquisition.

Other Acquisitions of Businesses

During 1997, the Company acquired certain other telecommunications and information services companies which were not material.

Unaudited results of operations for acquisitions consummated through December 31, 1997 other than Milliwave have not been included because they are not material to the consolidated statement of operations of the Company.

During 1996, a subsidiary of the Company acquired 100% ownership or a controlling interest in a number of companies engaged in the production and distribution of entertainment content. These acquisitions were treated as “purchases” for accounting purposes. The aggregate consideration for the acquisitions was approximately \$6.4 million, consisting of \$4.1 million in cash, \$800,000 in notes payable and 100,605 shares of the Company’s common stock or share equivalents, valued at \$1.5 million. The accounts of the acquired companies have been consolidated with the Company’s financial statements as of the date of acquisitions.

Acquisition of Assets

In October 1997, a subsidiary of the Company purchased certain telecommunication assets from US ONE Communications Corp., US ONE Communications Services, Corp. and US ONE Communications of New York, Inc. (collectively, the “Sellers”) which were entities in bankruptcy under chapter 11 of the United States Bankruptcy code. The aggregate purchase price was approximately \$81.3 million, of which approximately \$61.3 million was paid in cash at the closing and \$20.0 million is payable by WinStar in cash and/or shares of the common stock of WinStar, at WinStar’s discretion, on the effective date of the Sellers confirmed plan of reorganization. Included in fixed assets are certain equipment which the Company plans to sell within the near term.

Acquisition of Additional Licenses

During 1997, the Company executed agreements to acquire additional 38 GHz licenses, subject to FCC approval. The total purchase price for the licenses will be \$55.0 million, payable in shares of common stock of the Company or in certain instances, at the Company’s election, cash, which will be payable at the time of closing. During 1997, licenses acquired amounted to \$10.4 million of which \$7.5 million was paid in common stock at the closing. The remaining license acquisitions are expected to close within the next 12 months.

In connection with the acquisition of additional licenses, the Company entered into service agreements whereby the Company supplied and installed telecommunications equipment and provided related consulting services. Total revenues recorded under such agreements were \$4.2 million in 1997.

Notes to Consolidated Financial Statements—(Continued)**Note 2—Acquisitions—(Continued)***Acquisitions Subsequent to December 31, 1997***GoodNet**

On January 12, 1998, pursuant to an agreement between the Company and Telesoft Corp., the Company acquired Telesoft's Internet services subsidiary, ("GoodNet"), for a purchase price of approximately \$22.0 million, consisting of \$3.5 million cash and 732,784 shares of common stock of the Company valued at \$18.5 million. GoodNet is a national provider of Internet services, offering high-capacity data communication services.

Midcom Communications, Inc.

Effective January 21, 1998 (the "Closing Date"), pursuant to an agreement between the Company and MIDCOM Communications Inc. and its subsidiaries (collectively, "Midcom"), the Company acquired substantially all of Midcom's assets and businesses for a purchase price of approximately \$92.0 million in cash. On December 23, 1997, \$9.2 million of the purchase price was placed in escrow. On the Closing Date, \$48.5 million of the purchase price was paid in cash to Midcom and its designees and \$10.8 million of the purchase price was placed in escrow along with the initial deposit of \$9.2 million to secure Midcom's obligations to indemnify the Company in certain circumstances. In addition, \$23.5 million of the purchase price was placed in escrow on the Closing Date to secure Midcom's obligation to refund a portion of the purchase price in the event of a post-closing adjustment of the purchase price under the purchase agreement. Midcom is an entity in bankruptcy under Chapter 11 of the U.S. Bankruptcy Code.

Midcom is a provider of long distance voice and data telecommunications services primarily to small and medium-sized businesses, most of which are located in major metropolitan areas of California, Florida, Illinois, New York, Ohio and Washington.

Note 3—Investments in Marketable Equity Securities

The Company treats its investments in marketable securities as available for sale securities. As such, they are carried at market value, with the difference between the historical cost (which is determined on a FIFO basis) and the market value reflected in unrealized gains or losses on marketable equity securities, a component of stockholders' equity. During the year ended December 31, 1996, proceeds of \$6,400,000 were realized on the sale of marketable securities, which were sold at carrying value. During the year ended December 31, 1997, all such investments were sold, generating proceeds of approximately \$1,024,000 and a loss of approximately \$27,000, which was recognized in operations. At December 31, 1996 and 1997, unrealized losses of \$363,000 and \$0 were carried in stockholders' equity.

Note 4—Inventories

Inventory is comprised of film inventories of \$5,009,000 and \$10,296,000 at December 31, 1996 and 1997, respectively.

Notes to Consolidated Financial Statements—(Continued)**Note 5—Property and Equipment**

Property and equipment consist of the following:

	DECEMBER 31, 1996	DECEMBER 31, 1997	ESTIMATED USEFUL LIFE
	(IN THOUSANDS)		
Telecommunications equipment and software	\$58,788	\$293,728	5 to 10 years
Furniture, fixtures and other ...	3,354	12,504	4 to 5 years
Leasehold improvements	4,845	23,162	Lesser of life of the lease or life of the asset
	<u>66,987</u>	<u>329,394</u>	
Less accumulated depreciation and amortization	<u>(4,415)</u>	<u>(44,559)</u>	
	<u>\$62,572</u>	<u>\$284,835</u>	

Note 6—Intangible Assets

Intangible assets consist of the following:

	DECEMBER 31, 1996	DECEMBER 31, 1997	ESTIMATED USEFUL LIFE
	(IN THOUSANDS)		
Goodwill	\$13,726	\$ 17,865	5 to 20 years
Covenants not to compete and other	37	26	5 to 10 years
	<u>13,763</u>	<u>17,891</u>	
Less accumulated amortization	<u>(808)</u>	<u>(3,598)</u>	
	<u>\$12,955</u>	<u>\$ 14,293</u>	

Licenses, which are subject to renewal through February 2001, are amortized over a 40-year period, in accordance with industry practice. As of December 31, 1996 and 1997, the value of licenses was \$27.4 million and \$174.8 million, net of accumulated amortization of \$820,000 and \$4.9 million, respectively.

Notes to Consolidated Financial Statements—(Continued)**Note 7—Long-Term Debt**

Long-term debt consists of the following:

	DECEMBER 31, 1996	DECEMBER 31, 1997
	(IN THOUSANDS)	
12½% Guaranteed Senior Secured Notes Due 2004, WEC	\$ —	\$200,000
12½% Guaranteed Senior Secured Notes Due 2004, WEC II	—	50,000
14% Senior Discount Notes Due 2005	176,328	201,843
14½% Senior Deferred Interest Notes Due 2005	—	111,691
15% Senior Subordinated Deferred Interest Notes Due 2007	—	103,542
14% Convertible Senior Subordinated Discount Notes Due 2005	88,164	100,922
Other Notes Payable	<u>20,570</u>	<u>857</u>
Total	285,062	768,855
Less Current Portion	<u>19,901</u>	<u>386</u>
Total Long Term Debt	<u>\$265,161</u>	<u>\$768,469</u>

1995 Debt Placement

In October 1995, the Company completed a \$225.0 million private placement of debt securities with institutional investors (the "1995 Debt Placement"). The transaction was structured as a units offering with two components, \$150.0 million of Senior Discount Notes Due 2005 (the "Senior Discount Notes"), and \$75 million of Convertible Senior Subordinated Discount Notes Due 2005 (the "1995 Convertible Notes"), convertible at \$20.625 (subject to adjustment), a 10% premium over the closing price on October 18, 1995, the day of pricing. Both securities accrue interest at 14% per annum, with no interest payable during the first five years, and principal payable only at maturity in October 2005. Commencing April, 2001, both securities require the payment of interest only, in cash, until maturity. In addition, the 1995 Convertible Notes, including accretion thereon, will be automatically converted during the initial five-year period if the market price of the Company's common stock exceeds certain levels for thirty consecutive trading days, ranging from \$37.50 per share in the first year to \$44.00 per share in the fifth year.

In accordance with the terms of the 1995 Debt Placement, the Company consummated an exchange offer in 1996 with respect to the Senior Discount Notes, whereby these notes were exchanged for new notes which were identical in every respect to the original Senior Discount Notes except that the new notes were registered under the Securities Act of 1933.

1997 Debt Placements

In March 1997, the Company and WinStar Equipment Corp. ("WEC") issued an aggregate of \$300.0 million of notes in the March 1997 Debt Placement, consisting of (i) \$100.0 million of the 1997 Senior Deferred Interest Notes Due 2005 (the "1997 Senior Notes"), ranking pari passu with the 1995 Senior Discount Notes, and (ii) \$200.0 million of 1997 Guaranteed Senior Secured Notes Due 2004 (the "WEC Notes"). The Company also obtained a \$150.0 million facility ("Facility") from affiliates of certain of the initial purchasers of the Notes. In August 1997, WinStar Equipment II Corp. ("WEC II") issued, pursuant to the Facility, \$50.0 million of 1997 Guaranteed Senior Secured Notes Due 2004 (the "WEC II Notes") and in October 1997, the Company utilized the remaining \$100.0 million available under the Facility, issuing an aggregate of \$100.0 million principal amount of 1997 Senior Subordinated Deferred Interest Notes Due 2007 (the "October 1997 Notes").

Notes to Consolidated Financial Statements—(Continued)**Note 7—Long-Term Debt—(Continued)**

The obligations of WEC and WEC II under the WEC Notes and the WEC II Notes are unconditionally guaranteed by the Company and are secured by a security interest in the equipment and other property purchased by WEC and WEC II, as the case may be, with the proceeds thereof.

The WEC Notes bear interest at a rate of 12½% per annum, payable on March 15 and September 15, commencing September 15, 1997. The WEC Notes will mature on March 15, 2004 and are redeemable on or after March 15, 2002, at the option of the Company, in whole or in part, at certain specified prices. Additionally, in the event that by March 18, 1999, the Company has not applied the \$200.0 million of proceeds from the sale of the WEC Notes to fund the acquisition costs of Designated Equipment (as defined), the Company is required to redeem the WEC Notes in an aggregate principal amount equal to such shortfall at a redemption price of 112.5% of such principal amount, plus accrued interest, if any, to the date of redemption.

The WEC II Notes bear interest at a rate of 12½% per annum, payable on March 15 and September 15, commencing September 15, 1997. The WEC II Notes mature on March 15, 2004 and are redeemable on or after March 15, 2002, at the option of the Company, in whole or in part, at certain specified prices. Additionally, in the event that by August 8, 1999, the Company has not applied the \$50.0 million of proceeds from the sale of the WEC Notes to fund the acquisition costs of Designated Equipment, the Company is required to redeem the WEC II Notes in an aggregate principal amount equal to such shortfall at a redemption price of 112.5% of such principal amount, plus accrued interest, if any, to the date of redemption.

The 1997 Senior Notes are unsecured, senior indebtedness of the Company, rank *pari passu* in right of payment with all existing and future senior indebtedness of the Company, and are senior in right of payment to all existing and future subordinated indebtedness of the Company. The 1997 Senior Notes bear interest at a rate of 14½%. Until October 15, 2000, interest on the 1997 Senior Notes will accrue and compound semiannually, but will not be payable in cash. Interest on the Accumulated Amount (as defined in the 1997 Senior Notes Indenture) of the 1997 Senior Notes as of October 15, 2000 will be payable semiannually in cash on April 15 and October 15 of each year commencing April 15, 2001. The 1997 Senior Notes mature on October 15, 2005 and are redeemable on or after October 15, 2000, at the option of the Company, in whole or in part, at certain specified prices.

The October 1997 Notes are unsecured, senior subordinated obligations of the Company, rank *pari passu* in right of payment with the 1995 Convertible Notes and are junior in right of payment to all existing future senior indebtedness of the Company. The October 1997 Notes bear interest at a rate of 15% per annum, and are payable on March 1 and September 1, commencing September 1, 2002. Until March 1, 2002, interest on the Notes will accrue and be compounded semiannually on each Semi Annual Interest Accrual Date (as defined in the Indenture relating to the October 1997 Notes), but will not be payable in cash. Interest on the Accumulated Amount (as defined in the Indenture relating to the October 1997 Notes) of the Notes as of March 1, 2002 will be payable semiannually commencing September 1, 2002. The Notes will mature on March 1, 2007 and are redeemable on or after March 1, 2002, at the option of the Company, in whole or in part, at certain specified prices.

The terms of the Indentures relating to the 1995 and 1997 Debt Placements and the Certificates of Designation relating to certain of the Company's Preferred Stock agreements (see Notes 12 and 13) contain covenants placing certain restrictions on the ability of the Company to pay dividends or make other restricted payments, incur additional indebtedness, issue guarantees, sell assets, or enter into certain other specified transactions.

Other

On October 8, 1996, in connection with the purchase of Locate (see Note 2), the Company issued two promissory notes in the aggregate principal amount of \$17.5 million (the "Locate Notes") bearing interest at an annual rate of 8%. Interest on the Locate Notes was payable on a quarterly basis. The Notes were due on the earlier of April 8, 1997, or the day after the date on which the shares into which the Notes may be converted have been registered pursuant to an effective registration statement. During 1997, the Locate Notes including accrued interest were paid in full. At December 31, 1996, the aggregate amount of the Locate Notes, including accrued interest thereon, was \$17.8 million.

Notes to Consolidated Financial Statements—(Continued)**Note 7—Long-Term Debt—(Continued)**

In May 1995, a subsidiary of the Company issued \$7.5 million of five year collateralized convertible notes bearing interest at a rate of 7%, payable semiannually, with all principal due and payable on May 24, 2000. On December 28, 1995, the note holders converted \$3.75 million of the convertible notes and accrued interest thereon into 539,255 shares of common stock of the Company, and on November 24, 1996, converted the remaining outstanding notes of \$3.75 million principal amount plus accrued interest thereon into 554,880 shares of common stock of the Company.

Maturities of long-term debt at December 31, 1997, are as follows:

	(IN THOUSANDS)
1998	\$ 386
1999	277
2000	194
2001	—
2002	—
Thereafter	767,998
	<u>\$768,855</u>

Note 8—Fair Value of Financial Instruments

The fair value of the Company's financial instruments classified as current assets or liabilities, including cash and cash equivalents, short-term investments, accounts and notes receivable, and accounts payable and accrued expenses approximate carrying value, principally because of the short maturity of these items. Marketable equity securities are stated at quoted market value.

The carrying amounts of the long-term debt payable to financial institutions issued pursuant to two of the Company's subsidiaries' asset-based lending agreements approximate fair value because the interest rates on these agreements change with market interest rates.

The fair values of capitalized lease obligations approximate carrying value based on their effective interest rates compared to current market rates.

Notes to Consolidated Financial Statements—(Continued)**Note 8—Fair Value of Financial Instruments—(Continued)**

Estimated fair values of the Company's Long Term Notes Payable, Convertible Notes Payable, and Exchangeable Redeemable Preferred Stock which were calculated based upon quoted market prices, are as follows:

	DECEMBER 31, 1996		DECEMBER 31, 1997	
	CARRYING AMOUNT	FAIR VALUE (IN THOUSANDS)	CARRYING AMOUNT	FAIR VALUE
14% Senior Discount Notes Due 2005 . . .	\$176,328	\$179,455	\$201,843	\$233,144
14% Convertible Senior Subordinated Discount Notes Due 2005	\$ 88,164	\$ 94,141	\$100,922	\$216,228
14½% Senior Deferred Interest Notes Due 2005	—	—	\$111,691	\$132,000
15% Senior Subordinated Deferred Interest Notes Due 2007	—	—	\$103,542	\$122,500
12½% Guaranteed Senior Secured Notes Due 2004, WEC . . .	—	—	\$200,000	\$224,500
12½% Guaranteed Senior Secured Notes Due 2004, WEC II. . .	—	—	\$ 50,000	\$ 55,750
14¼% Series C Senior Cumulative Exchangeable Redeemable Preferred Stock	—	—	\$175,553	\$177,675

Note 9—Capital Lease Obligations

The Company leases telecommunications and other equipment through various equipment lease financing facilities. Such leases have been accounted for as capital leases.

Future minimum lease payments on these capital leases are as follows:

YEAR ENDING DECEMBER 31,	(IN THOUSANDS)
1998	\$ 9,941
1999	9,758
2000	8,321
2001	5,313
2002	1,834
Thereafter	194
Total payments	35,361
Less amount representing interest	(6,690)
Present value of minimum lease payments	<u>\$28,671</u>

The carrying value of assets under capital leases was \$15.9 million and \$28.0 million at December 31, 1996 and 1997 respectively, and is included in property and equipment. Amortization of these assets is included in depreciation expense.

Notes to Consolidated Financial Statements—(Continued)**Note 10—Commitments and Contingencies****a. Operating Leases**

The Company's offices, manufacturing and warehousing facilities, along with various equipment and roof access rights, are leased under operating leases expiring in 1998 through 2012. Certain leases contain escalation clauses based upon increases in the consumer price index.

Future minimum lease payments on noncancellable operating leases are as follows:

<u>YEAR ENDING DECEMBER 31,</u>	<u>(IN THOUSANDS)</u>
1998	\$ 13,800
1999	13,600
2000	13,200
2001	12,800
2002	12,400
Thereafter	<u>80,500</u>
	<u>\$146,300</u>

Rent expense for the ten month period ended December 31, 1995 and the years ended December 31, 1996 and 1997 were \$1.0 million, \$4.4 million and \$11.6 million, respectively.

b. Employment Contracts

Amounts due under employment contracts are as follows:

<u>YEAR ENDING DECEMBER 31,</u>	<u>(IN THOUSANDS)</u>
1998	\$2,485
1999	1,728
2000	<u>479</u>
	<u>\$4,692</u>

c. Litigation

The Company's residential long distance subsidiary, WinStar Gateway Network, Inc., occasionally receives inquiries from state authorities arising with respect to consumer complaints concerning the provision of telecommunications services, including allegations of unauthorized switching of long distance carriers and misleading marketing. The Company believes such inquiries are common in the long distance industry and addresses such inquiries in the ordinary course of business. In December 1996, the Federal Communications Commission ("FCC") and WinStar Gateway Network, Inc. ("WGN") entered into a consent decree which terminated an inquiry by the FCC into any alleged violations of unauthorized carrier conversions through the use of contest programs by certain of WGN's agents. The FCC cited WGN's efforts in identifying the problems caused by these agents and its proactive response in implementing self-directed remedial actions on its own as significant factors leading to the consent decree in lieu of initiating a formal investigation. The Company entered into assurances of voluntary compliance with the attorneys general of a number of states and has also initiated negotiations with other state authorities to resolve any claims by such authorities arising from the contest programs. The Company does not believe that the resolution of these issues will have a material adverse effect on the Company, its financial condition, or its results of operations.

In June 1996, the Company commenced an action for declaratory judgment against a former officer of WGN, who had notified the Company of his belief that he was entitled to the issuance of certain shares of common stock of the Company (or payment of the cash value thereof) under the terms of stock options granted to him during his employment with WGN. He has based his beliefs on standard antidilution language contained in his stock option agreement. Such language was designed and intended to adjust the number of shares purchasable thereunder in the event of a merger, capital restructuring or other similar event of the Company. As WinStar Communications, Inc. has

Notes to Consolidated Financial Statements—(Continued)**Note 10—Commitments and Contingencies—(Continued)**

never been subject to a merger or capital restructuring, the former officer was immediately notified of the Company's belief that his claim was without merit in law or fact. To expedite resolution of these issues, the Company currently is seeking declaratory judgment that it has no obligation to the former officer.

In January 1998, a stockholder suit, purported to be a class action, was commenced against the Company, its directors (and certain former directors) and one non-director officer in the Delaware Chancery Court seeking among other things, to invalidate certain portions of the Company's Stockholder Rights Plan, adopted in July 1997 (the "Rights Plan") (see Note 12), and to recover unspecified damages and attorneys' fees. The complaint alleges that certain provisions of the Rights Plan, particularly the so-called "Continuing Directors" provision, are not permitted under the Delaware General Corporation Law and the Company's Certificate of Incorporation. The Company believes strongly that these allegations are without merit and that the Rights Plan was properly adopted and is valid in its entirety. The Company is reviewing its available alternatives with regard to responding to this action.

The Company is also involved in miscellaneous claims, inquiries and litigation arising in the ordinary course of business. The Company believes that these matters, taken individually or in the aggregate, would not have a material adverse impact on the Company's financial position or results of operations.

d. Other

In connection with the purchase of telecommunications equipment including switches and radios, the Company enters into agreements with the suppliers of such equipment. As of December 31, 1997, the Company's noncancellable purchase commitments under these agreements were approximately \$31 million. In addition, the Company has guaranteed \$3.0 million of debt of Global Products.

Note 11—Income Taxes

SFAS No. 109 requires the use of the liability method in accounting for income taxes. Temporary differences and carryforwards that give rise to deferred tax assets and liabilities are as follows:

	DECEMBER 31, 1996	DECEMBER 31, 1997
	(IN THOUSANDS)	
Deferred tax assets:		
Net operating loss carryforward	\$ 48,218	\$ 134,550
Deferred interest expense	10,417	21,636
Allowance for doubtful accounts	433	1,140
Deferred compensation	—	748
Other	961	2,291
Gross deferred tax assets	60,029	160,365
Valuation allowance	(58,586)	(119,874)
Deferred tax asset net of allowance ...	<u>1,443</u>	<u>40,491</u>
Deferred tax liabilities:		
Depreciation	(1,354)	(5,998)
Amortization	(89)	(58,493)
Gross deferred tax liabilities	<u>(1,443)</u>	<u>(64,491)</u>
Net deferred tax asset (liability)	<u>\$ —</u>	<u>\$ (24,000)</u>

The federal net operating loss carryforward at December 31, 1997 is approximately \$345.0 million. If not utilized, the net operating loss carryforward will expire in various amounts through the year 2012.

Some of these losses are subject to utilization limitation under Section 382 of the Internal Revenue Code. However, the Company believes that substantially all of such losses will be available to offset future income.

Notes to Consolidated Financial Statements—(Continued)**Note 11—Income Taxes—(Continued)**

SFAS No. 109 requires a valuation allowance against deferred tax assets if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets may not be realized. The valuation allowances at December 31, 1996 and December 31, 1997, primarily pertain to uncertainties with respect to future utilization of net operating loss carryforwards.

On January 2, 1997, a net deferred tax liability of \$26.5 million was recorded in connection with the acquisition of Milliwave (see Note 2). This deferred tax liability resulted from the temporary difference between the book and tax basis of the acquired licenses, and related to the scheduled reversal of the temporary differences through amortization in years 2018 through 2036 that could not be offset by deferred tax assets existing at January 2, 1997, the date of the Milliwave acquisition.

During 1997, the Company recognized a deferred income tax benefit of \$2.5 million relating to the Company's net loss carryforwards. The Company recognizes income tax benefits to the extent of future reversals of existing temporary differences.

Note 12—Stockholders' Equity**Common Stock**

The authorized common stock of WinStar was increased during 1997 from 75.0 million shares to 200.0 million shares, \$.01 par value. The holders of common stock of WinStar are entitled to one vote for each share held of record on all matters submitted to a vote of stockholders. Although the Company has no present intention of paying any cash dividends (and is currently restricted from doing so under its indentures), holders of the common stock are entitled to receive ratably such dividends as may be declared by the Board of Directors out of funds legally available therefor. In the event of a liquidation or dissolution of WinStar, holders of the common stock are entitled to share ratably in all assets remaining after payment of all liabilities and the liquidation preferences of preferred shares. Holders of common stock have no preemptive rights and have no rights to convert their common stock into any other securities. There are no redemption or sinking fund provisions applicable to the common stock.

Preferred Stock

The authorized capital stock of the Company includes 15 million shares of "Blank Check" preferred stock, which may be issued from time to time in one or more series upon authorization by the Company's Board of Directors. The Board of Directors, without further approval of the stockholders, is authorized to fix the rights and terms, conversion rights, voting rights, redemption rights and terms, liquidation preferences and any other rights, preferences, privileges and restrictions applicable to each series of preferred stock.

Series A

On February 11, 1997, the Company sold 4.0 million shares of 6% Series A cumulative convertible preferred stock, par value \$.01, and 1.6 million warrants to purchase common stock of the Company, par value \$.01, for gross proceeds of \$100.0 million. The preferred stock earns a 6% annual dividend, payable quarterly in kind, and matures on February 11, 2002.

Two million shares of preferred stock became convertible beginning on August 11, 1997, and certain of these shares were converted at prices ranging from \$16.75 per share to \$18.86 per share, while the remainder became convertible on February 11, 1998. All remaining outstanding shares are convertible at \$25 per share. On February 11, 2002, any preferred stock still outstanding will be automatically converted into shares of the Company's common stock, unless the Company elects to pay, in lieu of conversion, the equivalent value in cash.

The warrants are exercisable at \$25 per share, and expire on February 11, 2002. The Company has the right to call the warrants after February 11, 2000, if the Company's common stock price has exceeded \$40 on each of the previous twenty trading days.

Notes to Consolidated Financial Statements—(Continued)**Note 12—Stockholders' Equity—(Continued)****Rights to Purchase Series B Preferred Stock**

Under a Rights Agreement dated as of July 2, 1997, between the Company and Continental Stock Transfer & Trust Company, as Rights Agent, which was adopted by the Board of Directors of the Company on July 2, 1997, holders of Common Stock of the Company received, as a dividend, preferred stock purchase rights (the "Rights") at the rate of one Right for each share of Common Stock held as of the close of business on July 14, 1997. One Right will also attach to each share of Common Stock issued thereafter. Currently the Rights are not separate from the Common Stock and are not exercisable, and the Rights will only separate from the Common Stock and become exercisable if a person or group acquires 10% or more of the Company's outstanding Common Stock (an "Acquiring Person") or launches a tender or exchange offer that would result in ownership of 10% or more the Company's outstanding common Stock. Each Right that is not owned by an Acquiring Person entitles the holder of the right to buy one one-thousandth of one share (a "Unit") of Series B Preferred Stock which will be issued by the Company. If any person becomes an Acquiring Person, or if an Acquiring Person engages in certain transactions involving conflicts of interest or in a business combination in which the Company's Common Stock remains outstanding, then the Rights Plan provides that each Right, other than any Right held by the Acquiring Person, entitles the holder to purchase, for \$70, Units with a market value of \$140. However, if the Company is involved in a business combination in which the Company itself is not the survivor, or if the Company sells 50% or more of its assets or earning power to another person, then the Rights Plan provides that each Right entitled the holder to purchase, for \$70, shares of the common stock of the Acquiring Person's ultimate parent having a market value of \$140.

At any time until ten days following the date on which a person acquires 10% or more of the Company's Common Stock the Company may redeem all (but not less than all) of the Rights for \$0.0001 per Right. The Rights expire in ten years. The Series B Preferred Stock will be junior, with respect to dividends and liquidation rights, to any other series of preferred stock of the Company. the Series B Preferred Stock has dividend and liquidation preferences over the Common Stock of the Company.

Series E Preferred Stock

In April 1995, the Company completed a private placement of 932,040 shares of Series E Convertible Preferred Stock ("Preferred Stock E") at a price of \$6.4375 per share, for gross proceeds of \$6 million. Preferred Stock E holders were entitled to dividends at the rate of 9% per annum, payable quarterly beginning on June 30, 1995. During the ten month period ended December 31, 1995, the entire 932,040 shares of Preferred Stock E were converted into 634,228 shares of common stock.

Note 13—Redeemable Series C Preferred Stock

On December 22, 1997, the Company issued 175,000 shares of Series C Senior Cumulative Exchangeable Preferred Stock Due 2007 ("Series C Exchangeable Preferred Stock"), for gross proceeds of \$175.0 million. The Company agreed to exchange the preferred stock for new preferred stock identical in every respect except that it would be registered under the Securities Act of 1933. During February 1998, the new preferred stock was registered.

Each share of Series C Exchangeable Preferred Stock has a liquidation preference of \$1,000 ("Liquidation Preference"). Dividends on the Series C Exchangeable Preferred Stock accrue from December 22, 1997 at the rate per share of 14 $\frac{1}{4}$ % of the Accumulated Amount (as defined) per annum, compounded semiannually on each June 15 and December 15, but will not be payable in cash, except as set forth in the next sentence. Commencing on the first June 15 or December 15 (each a "Dividend Payment Date") which is at least six months after the later of December 15, 2002, and the Specified Debt Satisfaction Date (as defined) (the "Cash Payment Date"), dividends on the Series C Exchangeable Preferred Stock will be payable in cash as a rate per annum equal to 14 $\frac{1}{4}$ % of the Accumulated Amount as of the Dividend Payment Date preceding such date. In the event that the Specified Debt Satisfaction Date shall not have occurred before December 15, 2002, the rate otherwise applicable to the Series C Exchangeable Preferred Stock shall be increased by 150 basis points from December 15, 2002, until the Dividend Payment Date falling on or after the Specified Debt Satisfaction Date. As of December 31, 1997 dividends totaling approximately \$553,000 have been accrued.

Notes to Consolidated Financial Statements—(Continued)**Note 13—Redeemable Series C Preferred Stock—(Continued)**

The Series C Exchangeable Preferred Stock is not redeemable prior to December 15, 2002. On or after December 15, 2002, the Series C Exchangeable Preferred Stock is redeemable at the option of the Company, in whole or in part, at specified redemption prices plus accumulated and unpaid dividends, if any, to the date of redemption. The Company is required to redeem the Series C Exchangeable Preferred Stock at the Liquidation Preference thereof, plus accumulated and unpaid dividends, if any, on December 15, 2007, out of any funds legally available therefor.

The Series C Exchangeable Preferred Stock ranks (i) senior to all existing and future Junior Stock (as defined) including the Series A Preferred Stock; (ii) on a Parity basis with all existing and future Parity Stock; and (iii) junior to all Senior Stock (as defined). In addition the Series C Exchangeable Preferred Stock is junior in right of payment to all indebtedness of the Company and its subsidiaries.

On any scheduled Dividend Payment Date following the Specified Debt Satisfaction Date, the Company may, at its option, exchange all but not less than all of the share of Series C Exchangeable Preferred Stock then outstanding for 14 $\frac{1}{4}$ % Senior Subordinated Deferred Interest Notes Due 2007 ("Exchange Debentures") in an aggregate Accumulated Amount equal to the aggregate Accumulated Amount of the shares of Series C Exchangeable Preferred Stock outstanding at the time of such exchange, plus accumulated and unpaid dividends to the date of exchange. The issuance of the Exchange Debentures upon each exchange will be registered under the Securities Act pursuant to a Registration Statement. Until the Cash Payment Date, interest on the outstanding Exchange Debentures if any, will accrue at a rate of 14 $\frac{1}{4}$ % of the Accumulated Amount per annum and will be compounded semiannually on each June 15 and December 15 (each an "Interest Payment Date") but will not be payable in cash except as set forth in the next sentence. Commencing on the first Interest Payment Date following the later of the Exchange Date (as defined) or the Cash Payment Date, interest will be payable in cash at a rate per annum equal to 14 $\frac{1}{4}$ % of the Accumulated Amount as of the Exchange Date. The Exchange Debentures, if issued, will be unsecured, senior subordinated obligations of the Company, subordinated in right of payment to all Senior Indebtedness (as defined) of the Company and to all indebtedness and other liabilities (including trade payables) of the Company's subsidiaries, and will rank *pari passu* with the Company's existing 1997 Senior Subordinated Notes and the Company's Convertible Notes.

Note 14—Stock Options and Stock Purchase Warrants

The Company has three stock option plans, the 1990 Plan, the 1992 Performance Equity Plan ("1992 Plan"), and the 1995 Performance Equity Plan ("1995 Plan"). The 1990 Plan is a non-qualified common stock incentive plan, as amended, pursuant to which options to purchase an aggregate of 150,000 shares of common stock may be granted to key employees of the Company as selected by the Board of Directors. The exercise price for shares covered by options granted pursuant to this plan will not be less than the fair market value of the shares on the date of the grant. The 1992 Plan authorizes the granting of awards up to 1.5 million shares of common stock to the Company's key employees, officers, directors and consultants. Awards consist of stock options (both non-qualified options and options intended to qualify as "incentive" stock options under the Internal Revenue Code), restricted stock awards, deferred stock awards, stock appreciation rights and other stock-based awards. The plan provides for automatic issuance of 10,000 stock options annually to each director on January 13, at the fair market value at that date, subject to availability. The 1995 Plan authorizes the granting of awards of up to 7.5 million shares of the Company's common stock to the Company's key employees, officers, directors and consultants. The 1995 Plan is similar to the 1992 Plan, except that the 1995 Plan does not provide for annual automatic annual director grants. The Company has also granted options to certain individuals outside the three plans. The options are exercisable over a period ranging from immediately to five years, depending on option terms.

Notes to Consolidated Financial Statements—(Continued)**Note 14—Stock Options and Stock Purchase Warrants—(Continued)**

The following table summarizes option activity for the ten months ended December 31, 1995 and the years ended December 31, 1996 and 1997:

	NUMBER OF OPTIONS (IN THOUSANDS)	WEIGHTED AVERAGE EXERCISE PRICE
Balance, February 28, 1995	6,149	\$ 3.85
Granted	3,896	\$ 9.13
Exercised	(2,092)	\$ 2.35
Canceled	(708)	\$ 3.21
Balance, December 31, 1995	7,245	\$ 6.90
Granted	4,057	\$18.55
Exercised	(921)	\$ 6.00
Canceled	(669)	\$12.72
Balance, December 31, 1996	9,712	\$11.43
Granted	3,905	\$15.62
Exercised	(1,214)	\$ 7.14
Canceled	(752)	\$16.18
Balance, December 31, 1997	<u>11,651</u>	\$13.27

As of December 31, 1997, options outstanding for 5.2 million shares were exercisable at prices ranging from \$1.50 to \$31.13, and the weighted remaining contractual life was 4.9 years.

The following table summarizes option data as of December 31, 1997:

RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING AS OF 12/31/97 (IN THOUSANDS)	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE AS OF 12/31/97 (IN THOUSANDS)	WEIGHTED AVERAGE EXERCISE PRICE
\$ 1.50–\$ 7.00	2,541	2.83	\$ 4.75	2,490	\$ 4.72
\$ 7.31–\$12.00	2,759	5.46	\$ 9.88	950	\$ 8.14
\$12.13–\$16.81	2,481	5.21	\$15.15	721	\$15.02
\$16.88–\$20.38	2,571	5.95	\$18.33	663	\$18.40
\$20.38–\$31.13	<u>1,299</u>	5.17	\$23.55	<u>384</u>	\$22.24
\$ 1.50–\$31.13	<u>11,651</u>	4.91	\$13.27	<u>5,208</u>	\$ 9.81

Compensation cost charged to operations, which the Company records for options granted to non-employees, was \$0, \$150,000 and \$0 in the ten months ended December 31, 1995 and the years ended December 31, 1996 and 1997, respectively.

The Company measures compensation in accordance with the provisions of APB Opinion No. 25 in accounting for its stock compensation plans. Accordingly, no compensation cost has been recorded for options granted to employees or directors in the ten months ended December 31, 1995 or the years ended December 31, 1996 or 1997.

Notes to Consolidated Financial Statements—(Continued)**Note 14—Stock Options and Stock Purchase Warrants—(Continued)**

The fair value of each option granted has been estimated on the grant date using the Black-Scholes Option Valuation Model. The following assumptions were made in estimating fair value:

	1995	1996	1997
Dividend Yield	0%	0%	0%
Risk-Free Interest Rate	6.0%	6.0%	6.0%
Expected Life after Vesting Period			
Directors and Officers	2.0 Years	2.0 Years	2.0 Years
Others	0.5 Years	0.5 Years	0.5 Years
Expected Volatility	66.88%	66.88%	66.88%

Had compensation cost been determined under FASB Statement No. 123, net loss and loss per share would have been increased as follows:

	TEN MONTHS ENDED DECEMBER 31, 1995	YEAR ENDED DECEMBER 31, 1996	YEAR ENDED DECEMBER 31, 1997
	(IN THOUSANDS)		
Net Loss Applicable to Common Stockholders:			
As reported	\$(15,857)	\$(83,723)	\$(255,363)
Pro forma for FASB No. 123	\$(21,795)	\$(98,765)	\$(272,497)
Loss Per Share—Basic and Diluted:			
As reported	\$ (0.70)	\$ (3.00)	\$ (7.68)
Pro forma for FASB No. 123	\$ (0.96)	\$ (3.54)	\$ (8.20)

The weighted average fair value of options granted during the years ended December 31, 1996 and 1997 was \$18.78 and \$15.63 per share, respectively.

During the initial phase-in period of FASB Statement No. 123, such compensation expense may not be representative of the future effects of applying this statement.

Warrants to purchase the Company's common stock were issued as follows (warrants in thousands):

	10 MONTHS ENDED DECEMBER 31, 1995		YEAR ENDED DECEMBER 31, 1996		YEAR ENDED DECEMBER 31, 1997	
	WARRANTS	PRICE/SHARE	WARRANTS	PRICE/SHARE	WARRANTS	PRICE/SHARE
Beginning						
Balance	—	—	400	\$ 12.00–\$13.00	400	\$ 12.00–\$13.00
Warrants Issued	400	\$ 12.00–\$13.00	—	—	1,600	\$ 25.00
Warrants						
Exercised	—	—	—	—	—	—
Warrants Expired	—	—	—	—	—	—
Ending Balance	<u>400</u>	\$ 12.00–\$13.00	<u>400</u>	\$ 12.00–\$13.00	<u>2,000</u>	\$ 12.00–\$25.00

Note 15—Related Party Transactions**Services Agreements**

In connection with the Company's merger with Milliwave, the Company entered into a Services Agreement with Milliwave in June 1996. Under the Services Agreement, a subsidiary of the Company installed radio links and managed Milliwave's communications network. Total fees under the Services Agreement and equipment sales paid by Milliwave to the Company were \$1.5 million through December 31, 1996.

Notes to Consolidated Financial Statements—(Continued)**Note 15—Related Party Transactions—(Continued)**

In connection with the Company' purchase of certain assets of Locate, the Company entered into a Services Agreement with Locate in April 1996. Under the Agreement, the Company provided consulting services to Locate regarding the operation of Locate's business. During the year ended December 31, 1996, Locate paid the Company approximately \$352,000 under the Services Agreement.

Private Exchange Transaction

On November 29, 1995, the Company acquired, in exchange for the issuance of 3,741,224 shares of its common stock ("Private Exchange"), substantially all of the assets of WinStar Companies, whose assets consisted of (i) all the outstanding capital stock of WinStar Services and WinStar Venture, two wholly owned subsidiaries of WinStar Companies, and (ii) 389,580 shares of the Company's common stock owned by WinStar Companies. The sole assets of WinStar Services and WinStar Venture were 2,117,183 shares of the Company's common stock and other securities of the Company that were exercisable or convertible into 1,429,633 shares of the Company's common stock. Accordingly, the Company issued 3,741,224 shares of the Company's common stock and, in exchange, acquired 3,936,396 shares of common stock and common stock equivalents. All of the Company's common stock and certain of the common stock equivalents received in the Private Exchange were included in Treasury Stock at December 31, 1995 and were retired in 1996. WinStar Companies, WinStar Services and WinStar Venture had no liabilities at the time of the closing of the Private Exchange other than a liability previously assumed by the Company or liabilities for which the Company is being indemnified. No claims for any liabilities have been received by the Company.

The new shares of the Company's common stock issued in the Private Exchange represented that number of shares which had an aggregate market value based upon the average of the closing sale price of the Company's common stock on the 30 trading days preceding November 15, 1995, the date as of which the exchange agreement regarding the above-described transaction was executed, equal to the market value of the Company's common stock (i) transferred by WinStar Companies to the Company, (ii) owned by WinStar Services and WinStar Venture and (iii) underlying certain other securities of the Company owned by WinStar Services and WinStar Venture which were convertible into or exercisable for shares of the Company's common stock, less the aggregate exercise price of such latter securities.

The stockholders of WinStar Companies included several of the Company's current executive officers one of whom is also a director. Simultaneously with the Private Exchange, WinStar Companies was dissolved and the new shares issued in the Private Exchange were issued directly to the stockholders of WinStar Companies in proportion to their equity ownership of WinStar Companies.

The Private Exchange was considered and approved by a special committee of independent and disinterested directors of the Company and an opinion from an independent investment banking firm that the Private Exchange was fair to the Company and its stockholders was obtained in connection with the Private Exchange.

Agreement with ITC Group, Inc.

In May 1994, the Company, WinStar Wireless, Inc. ("WWI") and ITC Group, Inc. ("ITC"), a telecommunications consulting firm, entered into a two-year agreement pursuant to which ITC advised the Company on the operations of its telecommunications business. ITC, together with the management and employees of WWI, developed and implemented a two-year operating plan for the Company's wireless telecommunications business. Pursuant to the terms of the consulting agreement, ITC made its consultants available to the Company and its subsidiaries. The Company paid ITC an annual base consulting fee of \$700,000 for the services of a core management team, as well as supplemental fees at agreed upon rates for additional consulting services rendered by ITC as necessary from time to time. Under the terms of the agreement, ITC provided up to 12 consultants at any given time. From March 1995 through September 1995, ITC was paid \$1 million in fees and expenses in connection with the consulting agreement, and the Company granted options to purchase an aggregate of 500,000 shares of its common stock for \$4.41 per share to certain consultants of ITC.